DEPARTMENT OF STATE REVENUE

40-20090224.LOF

Letter of Findings: 09-0224
Utility Receipts Tax
For the Years 2005, 2006, and 2007

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ISSUES

I. Intrastate and Interstate End User Revenues – Utility Receipts Tax.

Authority: IC § 6-2.3-1-4; IC § 6-2.3-2-1; IC § 6-2.3-3-4(b); IC § 6-8.1-5-1(c); Letter of Findings 40-20060364 (July 7, 2007); Letter of Findings 40-20080417 (October 15, 2008).

Taxpayer protests the imposition of Utility Receipts Tax (URT) on income attributable to the imposition of certain fees, charges, and "recoveries," on the ground that the income is excluded from the definition of "gross income" for URT purposes.

II. Interstate Revenues-NECA – Utility Receipts Tax.

Authority: IC § 6-2.3-1-4; IC § 6-2.3-1-6(2); Letter of Findings 40-20060364 (July 7, 2007); Supplemental Letter of Findings 40-20060364 (November 13, 2007); Telecommunications Act of 1996, 47 U.S.C. § 151 et seq. (2007).

Taxpayer argues that the assessment of Utility Receipts Tax on income attributable to the NECA "traffic sensitive pool" is erroneous because the income consists of wholesale receipts.

III. Indiana High Cost Fund – Utility Receipts Tax.

Authority: IC § 6-2.3-1-4; IC § 6-2.3-2-1; IC § 6-2.3-3-4; Letter of Findings 40-20060364 (July 7, 2007).

Taxpayer maintains the income recoveries from the Indiana "High Cost Fund" are not subject to the Utility Receipts Tax because the fund is a special vehicle established the by Indiana Utility Regulation Commission and distributions from the fund do not constitute "gross income" for URT purposes.

IV. Federal Universal Service Fund – Utility Receipts Tax.

Authority: IC § 6-2.3-3-4; IC § 6-2.3-3-4(b); Letter of Findings 40-20060364 (July 7, 2007); Letter of Findings 40-20080417 (October 15, 2008).

Taxpayer states that the income attributable to the "Federal Universal Service Fund" is not subject to the Utility Receipts Tax because the income consisted of federal subsidies and is not attributable to the retail sale of telecommunication services.

V. Indiana Traditional DEM Weighting Fund – Utility Receipts Tax.

Authority: IC § 6-2.3-3-4(b); Letter of Findings 40-20060364 (July 7, 2007).

Taxpayer maintains that income received from Indiana's Indiana Traditional DEM Weighting Fund (TDWF) is not subject to the Utility Receipts Tax because the TDWF receipts do not constitute gross receipts for URT purposes.

VI. Ten-Percent Negligence Penalty.

Authority: IC § 6-8.1-5-1(c); IC § 6-8.1-10-2.1(a)(3); IC § 6-8.1-10-2.1(a)(4); IC § 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer argues that imposition of the ten-percent "negligence penalty" was inappropriate because taxpayer's interpretation and application of the Utility Receipts Tax was reasonable and was based on the Department of Revenue's own prior interpretation of the law.

VII. Underpayment Penalty.

Authority: IC § 6-2.3-6-1; IC § 6-8.1-10-2.1(b).

Taxpayer maintains that it reasonably estimated the amount of Utility Receipts Tax owed Indiana and that the underpayment penalty is inappropriate.

STATEMENT OF FACTS

Taxpayer is a telephone company co-op which provides telephone, digital television, and Internet services to residents of several Indiana communities. The Department of Revenue (Department) conducted an audit review of taxpayer's tax returns and business records. As a result of the audit review, the Department assessed additional Utility Receipts Tax. Taxpayer objected to the audit results and submitted a protest to that effect. An administrative hearing was conducted during which taxpayer's representatives explained the basis for that protest. This Letter of Findings results.

I. Intrastate and Interstate End User Revenues – Utility Receipts Tax.

DISCUSSION

According to the audit report, taxpayer reported on its Utility Receipts Tax (URT) returns both interstate and intrastate "End User" revenue during the fiscal years ending September 30, 2005, and September 30, 2007. However these revenues were not reported during the fiscal year ending September 30, 2006. On the ground that the revenues were subject to Indiana's URT, the audit proposed an adjustment to include the absent End User

revenues.

Taxpayer maintains that the End User Revenues are not subject to the URT on the ground that the charges "fall directly within the express language and the intended purpose of IC 6-2.3-3-4(b) to exclude such fees or surcharges from the URT tax base because [the charges] are FCC approved and are not part of the price of retail telecommunications services sold to customers." Accordingly, taxpayer believes it is entitled to a credit adjustment and abatement of the additional assessment.

As a threshold issue, it is the taxpayer's responsibility to establish that the existing Utility Receipts Tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

The URT is imposed by IC § 6-2.3-2-1 as follows:

An income tax, known as the utility receipts tax, is imposed upon the receipt of:

(1) the entire taxable gross receipts of a taxpayer that is a resident or a domiciliary of Indiana....

"Gross receipts" for purposes of the Indiana's URT is defined at IC § 6-2.3-1-4 as follows:

"Gross receipts" refers to anything of value, including cash or other tangible or intangible property that a taxpayer receives in consideration for the retail sale of utility services for consumption before deducting any costs incurred in providing the utility services.

In summary, the URT is an income tax imposed on receipts from the retail sales of utility services for consumption by the purchaser. The utility services subject to tax include telecommunication services such as those provided by taxpayer.

According to taxpayer, "Interstate End User Revenues" are the "subscriber line charges... mandated by the FCC as end user contributions to the funding of the [National Exchange Carrier Association] NECA interstate access pools." These revenues are FCC fees in addition to the charges that the phone company charges for the local retail telecommunications services that it sells to its customers. According to taxpayer the "Interstate End User Revenues" fall within the express language of IC § 6-2.3-3-4(b) which states as follows:

Gross receipts do not include collections by a taxpayer of a tax, fee, or surcharge that is (1) approved by the Federal Communications Commission or the utility regulatory commission; and (2) stated separately as an addition to the price of telecommunication services sold at retail.

In other word, receipts that result from the collection of a "tax, fee, or surcharge" that were approved by either the FCC or the Indiana Utility Regulatory Commission (IURC) and are stated as separate line item on the customer's bill are exempt from the URT.

Taxpayer makes a similar argument in regards to the imposition of URT on "Intrastate End User Revenue." According to taxpayer, this revenue is collected pursuant to a decision by the Indiana Utility Regulatory Commission implementing its own end user access charges for long distance calling with the state of Indiana. This revenue is not subject to the URT because the charges "are not paid in consideration for the retail sale of telecommunications services."

The Department has previously addressed in detail the question of whether "Interstate End User Revenue" and "Intrastate End User Revenue" constitute a "tax, fee, or surcharge" and are not subject to the URT. In Letter of Finding 40-20060364 issued July 7, 2007, the Department concluded these charges were not taxes, fees, or surcharges, but that the "end user revenue charge is nothing more than a charge the customer pays for telecommunications service." See also LOF 40-20080417 (October 15, 2008). As explained in Letter of Findings 40-20060364;

The end user revenue charge is not a "tax, fee or surcharge" approved by the FCC. The end user revenue charge is not a "fee" because the FCC has not included it in either of the listed schedules of fees. See Telecommunications Act of 1996, 47 U.S.C. § 158-9 et seq. (2007). The end user revenue charge is not a "tax" charged to customers by the Federal or State government. The end user revenue charge is not a "surcharge." If the FCC wanted to designate the charge as a surcharge, it would have been thus named.

Taxpayer restates argument previously raised and thoroughly addressed in the previous Letter of Findings. The end user revenues are nothing more than a "charge" the customer pays for telecommunications services.

FINDING

Taxpayer's protest is respectfully denied.

II. Interstate Revenues-NECA – Utility Receipts Tax.

DISCUSSION

The National Exchange Carrier Association (NECA) pooling system receives contributions from phone companies and makes distributions to phone companies. The pooling system is designed to equitably apportion costs and income attributable to the provision of phone service to high cost customers, low income customers, schools, libraries, or rural health care providers. The pooling system has unique qualifications for companies receiving distributions based on the percentage of high cost, low income, or other specifically defined customers served. This revenue and cost information is annually provided to NECA which allocates or reallocates the contributions to the qualified phone companies.

The audit found that the distributions paid taxpayer by NECA were subject to the URT based on IC §

6-2.3-1-6(2) which states: "'Receives', as applied to a taxpayer means... the payment of a taxpayer's expenses, debits, or other obligations by a third party for the taxpayer's direct benefit." Taxpayer disagrees stating that "The NECA Settlement distributions are not received in consideration for the retail sale of telecommunications services, either directly or indirectly." Instead the distributions "represent supplemental whole-sale level distributions associated with providing access to long distance services and should be excluded from utility receipts tax."

The example cited in Letter of Findings 40-20060364 (July 7, 2007) is useful in explaining NECA's functionality:

> For example (and for illustrative purposes only), taxpayer collects $10.50 from each customer and holds these funds until the NECA[] determines the amount, if any, to be distributed to taxpayer. If the NECA[] determines that taxpayer is to received $10.50 or more for each customer, then taxpayer retains this $10.50 and receives distributions for the amount over the $10.50 from the NECA[] revenue pools. However, if the NECA[] determines that that taxpayer is to receive less than $10.50 for each customer, then the taxpayer remits those revenues to the NECA/USF to fund the pools.

The Federal Communications Commission was granted authority to create and oversee pooling systems such as NECA. See Telecommunications Act of 1996, 47 U.S.C. § 151 et seq. (2007). As explained previously, the URT is an income tax imposed on the receipts from retail sales of utility services for consumption by the purchaser. Further, gross receipts for purposes of the Indiana's URT include "anything of value... that a taxpayer receives in consideration for the retail sale of utility services for consumption before deducting any costs incurred in providing the utility services." IC § 6-2.3-1-4. "Receives," as defined for the purposes of the Indiana's URT, includes "the payment of a taxpayer's expenses, debts, or other obligations by a third party for the taxpayer's direct benefit." IC § 6-2.3-1-6(2). In other words, when a taxpayer provides utility services and directly benefits from something it receives for its expenses, debts, or obligations, then that taxpayer has gross receipts that are subject to the URT. Taxpayer receives distributions from the NECA revenue pool to recover its expenses attributable to the provision of utility services to certain defined categories of Indiana customers. Therefore, NECA is a third-party paying something of value for taxpayer's benefit and measured by the telecommunication services it provides to its Indiana retail customers.

Nonetheless, taxpayer asks that the Department adjust the initial assessment based upon a distinction between receipts from the "Traffic Sensitive Pool" and the "Common Line Pool" pursuant to the Department's previous decision in the Supplemental Letter of Findings (SLOF) 40-20060364 (November 13, 2007). As explained in that SLOF, "The 'Traffic Sensitive Pool' contains funds paid by long distance companies for use of Taxpayer's telephone lines." The SLOF found that "the receipts from the 'Traffic Sensitive Pool'... are not income from the retail sale of a utility service and are not subject to the URT."

In taxpayer's case, the Department finds no reason to depart from that initial finding. Taxpayer receives money from the NECA because it is providing phone and telecommunication services to its customers; this money is one portion of the "gross receipts" obtained from providing those particular services. Nonetheless, the Department has found that receipts from the "Traffic Sensitive Pool" constitute wholesale sales not subject to the URT.

Taxpayer's protest is sustained subject to the results of a supplemental audit intended to review taxpayer's documentation purporting to distinguish receipts from the "Traffic Sensitive Pool" from the balance of the receipts obtained from the NECA.

FINDING

Taxpayer's protest is sustained subject to verification by the supplemental audit.

III. Indiana High Cost Fund – Utility Receipts Tax.

DISCUSSION

The audit found that taxpayer received distributions from the Indiana High Cost Revenue Fund (IHCF). The audit found that the distributions were based upon the percentage of certain types of "high cost" customers such as those located in rural areas. The audit concluded that the distributions were subject to the URT. The taxpayer disagrees stating that the distributions are not "compensation for the retail sale of telecommunications services."

As previously explained, Indiana imposes the URT on the "entire taxable gross receipts of a taxpayer that is a resident or domiciliary of Indiana." IC § 6-2.3-2-1. However taxpayer argues that the distributions are subsidies funded by contributions received from designated intrastate long-distance carriers. Taxpayer believes that the distributions fall into the same category as government grants, insurance proceeds, loans, and proceeds from the sale of a capital asset.

"Gross receipts" for purposes of the Indiana's URT is defined at IC § 6-2.3-1-4 as follows:

> "Gross receipts" refers to anything of value, including cash or other tangible or intangible property that a taxpayer receives in consideration for the retail sale of utility services for consumption before deducting any costs incurred in providing the utility services.

An exclusion from the URT exists for "tax, fee, or surcharge" collections in IC § 6-2.3-3-4, as follows:

> (b) Gross receipts do not include collections by a taxpayer of a tax, fee, or surcharge that is:
>
> (1) approved by the Federal Communications Commission or the utility regulatory commission; and
>
> (2) stated separately as an addition to the price of telecommunications services sold at retail. (Emphasis

added).

The receipts at issue relate to an Indiana pooling systems that was created by the Indiana Utility Regulatory Commission ("IURC") to promote universal telecommunication service. Taxpayer receives distributions from the IHCF revenue pool to recover its expenses and obligations of providing retail utility services for consumption to categories of specifically defined Indiana customers. Thus, the IHCF is a third party paying something of value for Taxpayer's expenses and obligations from which the Taxpayer receives a direct benefit. Therefore, the receipts in the "Indiana High Cost Fund" accounts are gross receipts subject to the URT.

The issue raised by taxpayer is identical to that raised by the petitioner-taxpayer in Letter of Findings 40-20060364 (July 2, 2007). Taxpayer's arguments are essentially identical to the argument previously raised and – at this time – the Department finds no reason to depart from the holding of the July 2, 2007, Letter of Findings.

FINDING

Taxpayer's protest is respectfully denied.

IV. Federal Universal Service Fund – Utility Receipts Tax.

DISCUSSION

The audit found that revenue obtained from Federal Universal Service Fund (FUSF) is subject to the URT. As explained in the accompanying audit report, the FCC administers the FUSF for the benefit of rural telephone customers where the cost of providing telephone service would be disproportionately high without the supplemental income obtained from the FUSF. Each telecommunications provider is required to contribute to the FUSF based on a percentage of interstate and international end-user telecommunication revenues. In taxpayer's case, it elected to collect this amount from its customers in the form of a line item on each consumer's phone bill.

Taxpayer objects stating that distributions from the fund are approved by the FCC and not part of the customer's price for the retail sale of utility services and not subject to the URT under IC § 6-2.3-3-4(b).

Taxpayer asserts that since these charges were collected from the customers in a separately stated line item charge and were approved by the Federal Communications Commission ("FCC"), these receipts are a "tax, fee, or surcharge" collected from the customer not subject to the URT under IC § 6-2.3-3-4.

IC § 6-2.3-3-4 provides, as follows:

(b) Gross receipts do not include collections by a taxpayer of a tax, fee, or surcharge that is:

(1) approved by the Federal Communications Commission or the utility regulatory commission; and

(2) stated separately as an addition to the price of telecommunications services sold at retail.

The receipts at issue relate to a pooling system that was created by the Federal Communication Commission ("FCC") to promote universal telecommunication service. Taxpayer receives distributions from the pool to recover its expenses and obligations of providing retail utility services for consumption to categories of specifically defined Indiana customers. Thus, the FUSF is a third party paying something of value for Taxpayer's expenses and obligations from which the Taxpayer receives a direct benefit. Therefore, the receipts in the "Federal Universal Service Fund" accounts are gross receipts subject to the URT.

The issue raised by taxpayer is identical to that raised by the petitioner-taxpayer in Letter of Findings 40-20060364 (July 2, 2007). Taxpayer's arguments are essentially identical to the argument previously raised and – at this time – the Department finds no reason to depart from the holding of the July 2, 2007, Letter of Findings.

FINDING

Taxpayer's protest is respectfully denied.

V. Indiana Traditional DEM Weighting Fund – Utility Receipts Tax.

DISCUSSION

During the audit period, taxpayer received distributions from the "Indiana Traditional DEM Weighting Fund" (TDWF) and concluded that the distributions were subject to the URT because the receipts were attributable to an Indiana pooling system established to "assist in providing [telecommunication] services to customers who are more costly to service." Taxpayer argues that the TDWF is "Indiana's version of the federal universal service fund" and distributes subsidies to Indiana phone companies in order to support telephone service to rural and other high cost customers.

The TDWF was addressed in Letter of Findings 40-20060364 (July 2, 2007). The TDWF was created by the Indiana Utility Regulation Commission ("IURC") to promote universal telecommunication service. The TDWF was established prior to the enactment of the Telecommunications Act of 1996 and is separately administered until the IURC eventually forms the Indiana Universal Service Fund ("IUSF"), which will replace the TDWF.

Taxpayer has offered nothing to establish that distributions from the pooling arrangement constitute a "tax, fee, or surcharge" not subject to the URT. IC § 6-2.3-3-4(b). As noted in the July 2, 2007, LOF, the distributions constitute consideration received from a third-party in exchange for the provision of telephone service to specific categories of Indiana customers.

FINDING

Taxpayer's protest is respectfully denied.

VI. Ten-Percent Negligence Penalty.

DISCUSSION

Taxpayer believes that it is entitled to abatement of the ten-percent negligence penalty because its original

basis for calculating its URT liability was – according to taxpayer – " based on a bona fide interpretation[] of the applicable law; Was not due to negligence or intentional disregard of the law; and Was based on good faith and reasonable interpretations."

IC § 6-8.1-10-2.1(a)(3) requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. IC § 6-8.1-10-2.1(a)(4) requires a ten-percent penalty if the taxpayer "fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment."

IC § 6-8.1-10-2.1(d) states that, "If a person subject to the penalty imposed under this section can show that the failure to... pay the full amount of tax shown on the person's return... or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall wave the penalty."

Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC § 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed...."

Under IC § 6-8.1-5-1(b), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." An assessment – including the negligence penalty – is presumptively valid.

Given the totality of the circumstances and because of the purported legitimate – though competing and since discredited – interpretations of the URT, the Department is prepared to agree that taxpayer acted with the "reasonable care, caution, or diligence... expected of an ordinary reasonable taxpayer."

FINDING

Taxpayer's protest is sustained.

VII. Underpayment Penalty.

DISCUSSION

Taxpayer asks that the Department abate the ten-percent penalty which was assessed because taxpayer underpaid its estimated tax liability. Taxpayer makes this argument because it believes it had adequate grounds for originally determining URT Indiana tax liability as it did.

The penalty to which taxpayer refers is specified under IC § 6-2.3-6-1 which states as follows:

(a) Except as provided in subsections (c) through (e), a taxpayer shall file utility receipts tax returns with, and pay the taxpayer's utility receipts tax liability to, the department by the due date of the estimated return. A taxpayer who uses a taxable year that ends on December 31 shall file the taxpayer's estimated utility receipts tax returns and pay the tax to the department on or before April 20, June 20, September 20, and December 20 of the taxable year. If a taxpayer uses a taxable year which does not end on December 31, the due dates for filing estimated utility receipts tax returns and paying the tax are on or before the twentieth day of the fourth, sixth, ninth, and twelfth months of the taxpayer's taxable year.

(b) With each return filed, with each payment by cashier's check, certified check, or money order delivered in person or by overnight courier, and with each electronic funds transfer made, a taxpayer shall pay to the department twenty-five percent (25 [percent]) of the estimated or the exact amount of utility receipts tax that is due.

(c) If a taxpayer's estimated annual utility receipts tax liability does not exceed two thousand five hundred dollars ($2,500) the taxpayer is not required to file an estimated utility receipts tax return.

(d) If the department determines that a taxpayer's:

(1) estimated quarterly utility receipts tax liability for the current year; or

(2) average estimated quarterly utility receipts tax liability for the preceding year; exceeds five thousand dollars ($5,000), the taxpayer shall pay the estimated utility receipts taxes due by electronic funds transfer (as defined in IC 4-8.1-2-7) or by delivering in person or by overnight courier a payment by cashier's check, certified check, or money order to the department. The transfer or payment shall be made on or before the date the tax is due.

(e) If a taxpayer's utility receipts tax payment is made by electronic funds transfer, the taxpayer is not required to file an estimated utility receipts tax return.

(f) The penalty prescribed by IC 6-8.1-10-2.1(b) shall be assessed by the department on taxpayers failing to make payments as required in subsection (b) or (d). However, a penalty may not be assessed as to any estimated payments of utility receipts tax that equal or exceed:

(1) twenty percent (20 [percent]) of the final tax liability for the taxable year; or

(2) twenty-five percent (25 [percent]) of the final tax liability for the taxpayer's previous taxable year.

In addition, the penalty as to any underpayment of tax on an estimated return shall be assessed only on the difference between the actual amount paid by the taxpayer on the estimated return and twenty-five percent (25 [percent]) of the taxpayers's (sic) final utility receipts tax liability for the taxable year. (Emphasis added).

IC § 6-8.1-10-2.1(b) sets the amount of the penalty as ten percent.

Taxpayer was assessed a penalty because it underpaid its estimated tax liability. Taxpayer does not challenge the manner in which the amount of penalty was calculated but repeats its substantive argument that certain receipts were not subject to the state's Utility Receipts Tax. In effect, taxpayer asks the Department to abate the underpayment penalty because taxpayer presented a colorable argument justifying its failure to report the income. Taxpayer asks the Department to exercise a discretionary authority it does not have. The Department is without authority to abate the underpayment penalty.

FINDING

Taxpayer's protest of the underpayment penalty is respectfully denied.

SUMMARY

To the extent that taxpayer receives money from NECA's "traffic sensitive pool," taxpayer's protest is sustained subject to the results of a supplement audit. Except for abatement of the Negligence Penalty as discussed in Part VI above, the remainder of taxpayer's protest is denied in its entirety.

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